CHAPTER 15

REFORM INTERNATIONAL TAXATION

The Administration proposals would retain the basic structure for taxing foreign income of U.S. taxpayers that has evolved since 1913. This structure is intended to cause foreign income to bear a fair share of U.S. tax in a manner that does not distort investment decisions; at the same time, special measures reflect concern for the international competitiveness of U.S. business. Thus, the general rule is that U.S. taxpayers are subject to U.S. tax on their worldwide income. A credit is allowed against U.S. tax for foreign income taxes paid in order to avoid double taxation of foreign income which has been taxed by the country where the income is earned. The special measures include the deferral of U.S. tax on income earned by U.S.-controlled foreign corporations until that income is remitted to U.S. shareholders. (Certain tax haven income is, however, taxed to the U.S. currently even though not repatriated.) In addition, the first $80,000 of foreign earned income of a qualifying U.S. citizen or resident whose tax home is in a foreign country is excluded from income subject to U.S. tax.

In reaching the decision to continue the worldwide taxation of U.S. taxpayers with allowance for foreign tax credits, the Administration considered and rejected the alternatives of exempting foreign source income from U.S. tax, or taxing foreign source income but only allowing a deduction for foreign taxes. While an exemption approach would in some circumstances facilitate overseas competition by U.S. business with competitors from countries that tax foreign income on a favored basis, such an approach also would favor foreign over U.S. investment in any case where the foreign country's effective tax rate was less than that of the United States. Moreover there would be a strong incentive to engage in offshore tax haven activity. The longstanding position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions. Exempting foreign income from tax would favor foreign investment at the expense of U.S. investment. The other alternative, to allow only a deduction for foreign taxes, would not satisfy the objective of avoiding double taxation. Nor would it promote tax neutrality; it would be a serious disincentive to make foreign investments in countries where there is any foreign income tax.

The Administration proposals therefore would correct certain problems in the existing system of U.S. taxation of international transactions. When combined with the proposed reductions in tax rates, the net effect of the Administration proposals would be to reduce the U.S. tax burden on foreign income. By 1990, after the rate reductions are fully phased-in, the U.S. tax collections on foreign income would be $9.4 billion, compared with $11.4 billion if current

law continued to apply. This 18 percent net reduction in U.S. tax on foreign income would enhance the overall competitiveness of U.S. business abroad.

The Administration strongly supports a foreign tax credit as the appropriate measure to avoid international double taxation. However, the existing overall foreign tax credit limitation allows high foreign taxes to be credited against U.S. tax on other low-taxed foreign income. This allows a high tax country's tax to be utilized to offset the residual U.S. tax that otherwise would be imposed with respect to low-taxed foreign income, and as a consequence favors foreign over U.S. investment. The Administration proposal to adopt a per-country limitation on the foreign tax credit would limit the foreign tax credit to its function of eliminating international double taxation of foreign income by restricting the ability to average foreign income subject to high and low foreign effective tax rates.

The other Administration proposals are intended to rationalize and improve existing law relating to the taxation of international t-ransactions. Certain income source rules and expense allocation rules would be modified to associate income more appropriately with the source of the underlying economic activity and associate interest expense with assets supported by the borrowing. The proposals relating to taxation of U.S. branches of foreign corporations, tax relationships with U.S. possessions and taxation of foreign exchange gains and losses represent important technical improvements to existing law. While a number of these changes could be made admin-istratively under current law, it is appropriate to describe such proposals in conjunction with tax reform proposals requiring legislative amendments.

REFORM FOREIGN TAX CREDIT

General Explanation

Chapter 15.01

Current Law

Foreign Tax Credit Limitation

The United States taxes its citizens and residents, including U.S. corporations, on their worldwide income. To avoid international double taxation when the foreign income of a U.S. citizen, resident or corporation is taxed by a foreign country, the United States permits a taxpayer to elect to credit the foreign income taxes paid against his U.S. tax liability. The amount of foreign tax credit which may be claimed in any taxable year is limited to the U.S. tax otherwise imposed on foreign source income for that year. This limit is measured as the portion of U.S. tax, before credit, corresponding to the portion that foreign taxable income is of worldwide taxable income. The limitation is calculated on an overall basis; that is, the amount of credit potentially allowable is the aggregate of income taxes paid to all foreign countries, and foreign source taxable income is the aggregate of all taxable income from sources outside the United States. In effect, each taxpayer is allowed to average foreign effective tax rates above and below the U.S. rate. Only if the average foreign tax rate exceeds the U.S. tax rate are any potential credits denied. Potential credits that exceed the limitation in a particular year may be carried back two years and forward five years.

The foreign tax credit limitation is calculated separately for several different categories or baskets of income, including a passive interest income basket. The separate basket rules prevent taxpayers from averaging for foreign tax credit limitation purposes foreign tax rates on different classes of income that may be easily moved from one source to another or that are typically subject to lower aggregate foreign tax. Special limitations also apply in determining the amount of credit that can be claimed with respect to income derived from oil and gas related activities.

Indirect Credit for Foreign Taxes Paid by Foreign Subsidiaries

All taxpayers are allowed to credit foreign income taxes that they pay directly. In addition, U.S. corporations are allowed to credit a share of taxes paid by foreign subsidiary corporations when the earnings of the subsidiary become subject to U.S. tax. This is called the "indirect" or "deemed paid" foreign tax credit. The share of foreign taxes paid by the foreign corporation for a taxable year that is eligible for the indirect credit is related to the share of that corporation's "accumulated profits" that is repatriated as a dividend

to the U.S. parent corporation. Shareholders that are currently taxable under the provisions of subpart F on income of a controlled foreign corporation are also entitled to an indirect credit for the foreign taxes paid by that corporation. The share of taxes eligible for the indirect credit under subpart F is related to the share of "earnings and profits" of the controlled foreign corporation for the taxable year included in the shareholder's income. These taxes are subject to the limitation described above.

For purposes of computing the indirect credit with respect to an actual dividend distribution, distributions are treated as made out of the most recently accumulated profits of the distributing corporation. Distributions made during the first 60 days of a taxable year are generally treated as paid out of the prior year's accumulated profits. Foreign taxes paid are required to be associated with the accumulated profits to which they relate on a year by year basis. For purposes of computing the indirect credit with respect to a subpart F inclusion, taxpayers are required to associate foreign taxes with earnings and profits of the current year.

Accumulated profits as calculated for purposes of the indirect credit with respect to actual distributions and earnings and profits as calculated for purposes of the indirect credit with respect to subpart F inclusions may differ in several respects. For example, the subpart F rules require adjustment to U.S. financial and tax accounting principles to be made only if the adjustment is material. Differing foreign currency translation rules also apply as discussed in more detail in Ch. 15.04. Existing regulations permit, but do not require, a corporation to calculate accumulated profits and earnings and profits on the basis of the same accounting and tax adjustments although different currency translation rules are mandatory.

In calculating the indirect credit, dividends received are generally characterized as from foreign or domestic sources on the basis of the place of incorporation and other tax attributes of the corporation paying the dividend. Existing law also contains rules preventing the conversion of U.S. source income into foreign source income and interest income into non-interest income by routing that income through foreign affiliates.

Reasons for Change

Foreign Tax Credit Limitation

The purpose of the foreign tax credit is to relieve international double taxation of foreign income. Double taxation would be fully relieved if income derived from each separate transaction were treated separately for credit purposes and the U.S. tax were offset by a credit for the foreign tax paid with respect to that income. Any departure from a transactional approach to crediting foreign tax will permit some averaging of foreign taxes and will therefore involve some

surrender of the residual tax imposed by the United States on foreign income that is taxed by foreign countries at rates below the U.S. rate.

The existing law prohibits averaging of foreign taxes on passive interest income, which is often exempt from foreign tax under foreign law or treaties or subject only to withholding tax at modest rates, with foreign taxes on other foreign income. Foreign tax on other types of passive income, including portfolio dividends, is permitted to be averaged with tax on active business income, even though this passive income may also be subject to foreign tax at low rates. The existing overall limitation also permits high foreign taxes in one country and low foreign taxes in a second country to be averaged in computing the available foreign tax credit. The deferral of U.S. tax on foreign subsidiary earnings until those earnings are repatriated allows taxpayers to control this averaging process by controlling the timing of foreign subsidiary dividend distributions.

The averaging of effective rates permitted under current law is undesirable for at least two reasons. First, the averaging permitted by an overall limitation gives taxpayers with operations in a high tax country an incentive to invest in low tax countries. For a taxpayer with excess foreign tax credits, low tax country investments may be more attractive than investments in the United States that generate a higher pre-tax economic return simply because of the possibility of using the excess credits to offset a portion of the U.S. tax otherwise due. In that way the effective rate of overall tax on the foreign investments can be reduced below the effective rate that would apply if the investment in the low tax country had been made in the United States. The overall limitation under current law thus causes economic decisions to be distorted purely for tax advantage.

This potential for distortion of economic decision making that results from the overall limitation exists at the U.S. tax rates prevailing under existing law. However, the incentives to invest in low tax countries may be more pronounced when U.S. corporate tax rates are greatly reduced under the tax reform proposal. The substantial proposed tax rate reduction will cause many more taxpayers to operate in an excess foreign tax credit position. The additional excess credits created by the proposed rate reduction will result in a significant opportunity for reducing a corporation's overall tax burden by making investments in low tax countries instead of the United States. A similar strong incentive will be created to generate averageable low tax passive income that is not subject to the existing separate basket rules and definitions.

A second problem is that the overall limitation permits some foreign countries to maintain high tax rates without reducing their ability to attract U.S. investment. Under an overall limitation system, a company with operations in a low tax country is able to invest in a high tax country without bearing the full burden of the high foreign tax. The overall limitation inappropriately requires the

U.S. Treasury to bear the cost of high foreign tax rates on U.S. businesses to the extent of its claim to a residual tax on low tax foreign income. A neutral U.S. tax system would require U.S. corporations to bear the full burden of high foreign taxes rather than allowing these costs to be passed on to the U.S. Treasury and other taxpayers through the foreign tax credit mechanism. As a result of adopting a per country limitation, high tax countries may find it appropriate to reevaluate their rules for taxing U.S. capital. Such countries would have a stronger incentive to adopt lower taxes either unilaterally or through the treaty process.

It is impossible as a practical matter to eliminate all tax rate averaging by calculating the foreign tax credit on a transactional basis. Taxes are not ordinarily levied on such a basis and the technical complexity of such a system would make it unworkable. The question therefore becomes how much tax rate averaging to permit in the system and at what cost in terms of the complexities of compliance and enforcement.

At a minimum, passive and active income should be separated for credit purposes in order to prevent averaging of easily movable types of income that are generally taxed in different ways by most foreign countries. Calculating the foreign tax credit limitation on a per country basis would go further and prevent averaging between income from high tax and low tax countries. A separate basket, per country limitation would therefore provide as close a proxy as practically possible for a separate transaction type limitation calculation. Such a limitation would effectively restrict the foreign tax credit to its purpose of eliminating double taxation.

Indirect Credit

The requirement that accumulated profits and earnings and profits be associated with foreign taxes on an annual basis for purposes of the indirect credit can lead to seriously defective results. Where a subsidiary incurs a foreign loss under U.S. tax principles in a year in which it is required to pay foreign tax under foreign tax principles, an indirect foreign tax credit may not be available for the foreign tax paid. See Rev. Rul. 74-550, 1974-2 C.B. 209. On the other hand, taxpayers are sometimes able to accelerate or increase artificially the available credit simply by appropriately controlling the timing of receipt of income, payment of foreign tax, and distribution of earnings.

The different methods of computing accumulated profits and earnings and profits in calculating the indirect credit with respect to actual distributions and subpart F deemed distributions can cause very different foreign tax credit results to follow from a current distribution of non-subpart F earnings and a subpart F inclusion, even though the transactions may be economically equivalent. Taxpayers are free to accelerate credits by intentionally generating subpart F income (for example, by making a loan to a controlling U.S. share-

holder) if the earnings and profits calculation results in a larger credit than would the accumulated profits calculation applicable to an actual distribution.

Proposal

Per Country Foreign Tax Credit Limitation

The amount of income tax paid to a foreign country which may be claimed as a foreign tax credit in any year will be limited to the U.S. tax on income from that country. The limitation with respect to each country will be a fraction of the total pre-credit U.S. tax equal to the ratio of taxable income from that country to worldwide taxable income. United States tax principles and rules for determining the source of income will apply for purposes of calculating the taxable income from individual countries.

The separate baskets of income defined under current law will be retained. The separate passive income basket, currently limited to passive interest income, will be broadened to include dividends received from companies in which the taxpayer owns less than a 10 percent interest and gains derived from the disposition of assets that generate passive income (other than Corn Products type assets). The Administration will continue to consider whether other types of easily movable income that are generally taxed abroad on a gross withholding basis should also be included in the passive income basket. Interest, rents and royalties received from subsidiaries or other affiliated corporations will be treated as active business income, however, and will not be included in the passive income basket.

Special Issues Under the Direct Credit

Sourcing of Income and Related Issues. Taxpayers will be required to calculate their income from sources within individual countries for purposes of computing the foreign tax credit. The source rule changes proposed in Ch. 15.02 are designed in part to facilitate such separate country sourcing.

Situations will arise, as they do under current law, in which the United States and the foreign country characterize income as being derived from different sources. For example, income received for architectural and engineering services performed in the United States but relating to foreign construction projects may be treated as taxable local source income by the foreign country, but will be treated as U.S. source income in the United States. Similarly, because of differing tax accounting rules, depreciation allowances, and other reasons, income may be taxable in a foreign country in taxable years either before or after the year in which income would be includible under U.S. tax principles. Without rules to minimize the effect of temporal mismatching of income and conflicting source rules, timing and sourcing differences could result in a permanent loss of credits.

Two changes in the operation of the credit will be made to help alleviate mismatching problems that arise or are made potentially more severe under a per country limitation. First, to reduce the consequences of temporal mismatching, the carryforward period for excess credits will be extended to ten years. A longer carryback period would arguably also be appropriate. However, because the carryback of excess credits creates serious administrative difficulties by requiring recomputation of past years' taxes, it is not practical to extend the carryback period beyond two years.

Second, to alleviate severe mismatching of income by source, taxpayers will be permitted to elect whether to deduct or to credit foreign taxes on a country by country basis. This will permit taxpayers to obtain a deduction for foreign taxes paid to a particular country even if they have no income, or a taxable loss, in that country under U.S. tax principles, without losing their ability to obtain a foreign tax credit for taxes paid to other countries. Such changes would not be necessary or acceptable under an overall limitation.

Allocation of Expenses. The expense allocation rules of existing law require only that expenses be divided between U.S. and foreign source income and do not require a separate country by country subdivision of the expenses allocated to foreign income. Under the proposal, expenses will be required to be allocated and apportioned to separate countries. Consideration will be given to applying simplified rules for allocating and apportioning expenses which otherwise would require asset based allocation.

Losses. Three alternative treatments of losses would be possible under a per country limitation. First, losses could be permitted to offset only other subsequent income from the loss country. Such a rule would lead to excessively harsh results if a loss operation in a foreign country were abandoned without recouping the losses. Second, losses could be permitted to offset only U.S. income, which would tend to transfer much of the economic risk of a foreign loss to the U.S. Treasury. There is, however, no reason to conclude that foreign losses should be more closely associated with U.S. income than with other income. Third, losses could offset a pro rata portion of all income, irrespective of source. The proposal adopts this third option by requiring that losses be spread to all income rather than simply reducing the tax on U.S. income. In the year a loss occurs, it would be prorated against income earned in all other countries (including the United States) and separate baskets in proportion to each separate country and separate basket share in that year's worldwide taxable income. The proration of losses in this manner would be required whether the taxpayer elected to deduct or credit the foreign taxes paid to the loss country for the year in question.

If the taxpayer earns income in the loss country in a subsequent year it will be re-sourced in proportion to the previous loss allocation. If the loss had the effect of increasing or creating

excess foreign tax credits in a country the subsequent resourcing of income in that country will make additional credits available. If the loss proration had the effect of reducing the U.S. tax on either domestic or low taxed foreign income, resourcing the subsequent income should recapture the previously foregone tax.

As noted above, in applying these loss rules, the United States will be treated as any other country except that U.S. income will be treated as in a single basket. A share of any loss in a foreign country will be allocated to U.S. income and result in the reduction of U.S. tax liability. Similarly, a U.S. loss will be allocated to foreign income and prorated over all countries and baskets. Subsequently earned U.S. source income will be resourced in proportion to the initial loss proration.

Rules Relating to Oil and Gas Income. The limitations contained in existing section 907(a) on the creditable foreign tax imposed on oil and gas extraction income will be retained and applied on a separate country basis. After reducing the creditable tax in accordance with these rules, the ordinary rules for computing the foreign tax credit limitation, including the loss allocation rules, will be applied to taxpayers in the oil and gas industry. Accordingly, an extraction loss in one country would not reduce the creditable foreign extraction taxes paid to another country. However, a foreign oil and gas extraction loss in any country will be prorated against other income from that and other countries, including income from non-extraction activities, and be fully recaptured when income ultimately is earned in the loss country.

Rules for Applying a Per Country Limitation to the Indirect Credit

Under the proposal, foreign taxes would be matched as closely as possible with the foreign income to which they relate. Tracing income and taxes to the proper country and basket of income for purposes of the indirect credit under a multi-tiered corporate structure raises several issues.

Source of Dividend Distributions. The ordinary U.S. source rule for dividend income sources the dividend at the place of incorporation of the payor. Application of such a rule in calculating the indirect credit on a separate country basis would permit a taxpayer to use a foreign holding company to average high and low tax foreign source income from lower tier corporations, thereby avoiding the purpose of the per country limitation. Such averaging would not be permitted if the same income were earned either through a branch or as subpart F income. In order to preserve the integrity of the per country limitation, dividends from subsidiaries earning income in more than one country will ordinarily be required to be resourced for purposes of calculating the foreign tax credit limitation.

Dividends will be sourced for foreign tax credit purposes pro rata to the country or countries from which the payor corporation has derived the accumulated profits out of which the dividend is paid. Thus, if a subsidiary has derived 40 percent of its accumulated profits from country X and 60 percent of its accumulated profits from country Y, 40 percent of a dividend it pays will be sourced in country X and 60 percent of the dividend will be sourced in country Y. Taxpayers receiving dividends from subsidiaries which derive less than 10 percent of their accumulated profits from countries outside their country of incorporation may elect not to have a portion of those dividends resourced under these rules, provided no election is made to use the tax reallocation rules described below. Dividends paid out of profits accumulated prior to the effective date will be sourced in the distributing corporation's country of incorporation. The rules of existing section 904(g) for maintaining U.S. source will be retained.

Maintaining Separate Basket Character of Dividend Income. Dividends will also be required to be traced to separate baskets in proportion to the distributing corporation's accumulated profits derived from separate basket income under rules similar to those of current section 904(d). For example, if ten percent of a foreign subsidiary's accumulated profits are derived from passive basket income, ten percent of a dividend paid by that subsidiary will be treated as passive basket income in the hands of the shareholder. These rules will prevent taxpayers from using a multi-tiered structure to blend income in the various separate baskets. The rules will require corporations at each level of the corporate structure to maintain separate basket accounts in each country from which they derive income. Similar rules for maintaining the separate basket character of other payments to related parties attributable to separate basket income of the payor will be considered.

Interaction of the Indirect Credit with Subpart F. Under the provisions of subpart F, certain income of foreign corporations controlled by U.S. shareholders is taxed currently to those U.S. shareholders. A credit for the foreign taxes paid with respect to that income is allowed to the shareholder. When income that has been previously taxed under subpart F is subsequently distributed, it is not taxed a second time. These rules will be maintained under the proposal. Dividend distributions from foreign subsidiaries will be treated as having been paid first out of previously taxed subpart F income and will be excluded from the shareholder's gross income. Only the portion of any dividend that exceeds previously taxed income will be subject to the dividend resourcing and recharacterization rules described above. Rules of existing law allowing credits for withholding taxes on distributions of previously taxed income will be retained.

Allocation of Foreign Taxes to Income from Lower Corporate Tiers. Subject to the exceptions described below, taxes on net income paid to a foreign country will be treated for foreign tax credit limitation purposes as taxes of the country to which they are paid. Gross basis

withholding taxes on dividends will be treated as if they had been paid to the country or countries in which the dividend income is resourced under the rules described above. Gross basis withholding taxes on non-dividend income such as interest, rents and royalties will be treated as paid to the country that imposes the tax.

Where a foreign subsidiary of a U.S. company is taxed on a worldwide net income basis in its country of residence and derives more than 10 percent of its income from sources outside of its country of residence, its dividend payments will be at least partially resourced under the rules described above. If taxes paid in the country of residence were not also resourced, mismatching of tax and income could occur in some circumstances. Accordingly, such taxpayers will be permitted to elect to treat a portion of a subsidiary's residence country tax as if it were paid to other countries in which the subsidiary derived income. The amount of foreign tax that may be reallocated in this manner will be calculated by (i) computing the ratio of total foreign income tax (excluding gross basis withholding tax) paid to all countries with respect to the distribution to the total distributed accumulated profits; (ii) multiplying the distributing subsidiary's distributed accumulated profits from sources in the residence country by that ratio; and (iii) subtracting the resulting amount from the total income tax (excluding withholding tax) paid to the residence country with respect to the distributed accumulated profits. The resulting amount will be reallocated to other countries in proportion to the subsidiary's accumulated profits from sources in those countries. However, no amount of residence country tax need be allocated to countries in which the effective tax rate on the distributed accumulated profits (calculated under U.S. principles) equals or exceeds the ratio computed in step (i) above.

Allocation of Foreign Subsidiary Expenses. Current law requires that expenses incurred by U.S. companies be allocated among separate baskets of income and between domestic and foreign source income in determining net foreign source taxable income for purposes of the foreign tax credit limitation calculation. The proposal would retain this requirement, modified as described above, to enable expenses to be allocated to specific foreign sources. Expenses incurred by foreign subsidiaries would also be required to be allocated among separate baskets of income and individual foreign countries. Consideration will be given to applying simplified rules for purposes of allocating foreign subsidiary expenses.

Other Changes to the Indirect Credit

For purposes of computing the indirect foreign tax credit, dividend distributions and subpart F inclusions will be deemed to be made from the pool of all of the distributing corporation's accumulated profits (or earnings and profits in the case of subpart F inclusions) rather than being related to accumulated profits (or earnings and profits) from any particular year. Earnings of the current year would be included in the relevant pool. The rule

treating distributions made in the first 60 days of a taxable year as made from the prior year's accumulated profits would be repealed. A dividend or subpart F inclusion will similarly be deemed to bring with it a pro rata share of the accumulated foreign taxes paid by the subsidiary.

Accumulated profits will be required to be calculated in the same manner as earnings and profits. In general, the earnings and profits and accumulated profits computations will be required to be made under rules similar to those contained in the existing regulations under section 964. The rules for translating foreign currency contained in the existing section 964 regulations, however, will be modified as described in Ch. 15.04.

Effective Date

The proposals would be effective for taxable years beginning on or after January 1, 1986. A five year carryforward of excess foreign tax credits existing on the effective date would be permitted subject to an overall limitation. The ten year carryforward period contained in the proposal would apply only to excess credits generated after the effective date. Excess credits generated after the effective date would not be permitted to be carried back to pre-effective date years.

Pre-effective date overall losses would be required to be recaptured out of post-reform income. Each year until such losses are exhausted, taxpayers will determine the amount they would have been required to recapture under pre-effective date law. This amount of foreign income would be recharacterized as U.S. source. Rules would be prescribed to determine the countries from which this income would be deemed to have been taken.

The proposal to treat dividends as paid out of a pool of accumulated profits would apply only prospectively. Future dividends would be treated as paid first out of the pool of all accumulated profits derived by the payor after the effective date. Dividends in excess of that accumulated pool of post-effective date earnings would be treated as paid out of pre-effective date accumulated profits under the ordering principles of existing law.

Analysis

The adoption of a per country foreign tax credit limitation will limit the ability of taxpayers to average low foreign taxes imposed in one country with high foreign taxes imposed in a second country in calculating the foreign tax credit. The broadening of the passive income basket will limit the ability of taxpayers to average foreign taxes on types of income typically taxed abroad at low or zero tax rates with foreign taxes on other types of income that are typically subject to higher aggregate foreign taxes. Rules for tracing source and character of income will preserve neutrality in the application of a per country limitation between foreign branches and foreign

subsidiaries by preventing use of creative corporate structures to avoid the effect of the per country and separate basket rules.

By restricting the ability of taxpayers to average high and low foreign taxes, the proposed changes will limit the foreign tax credit to its function of eliminating international double taxation of foreign income. The changes will preserve the residual U.S. tax on lightly taxed foreign income while causing other countries to bear the full investment disincentive effects of their own high tax rates. The proposed changes would help to counteract the incentives otherwise created by the proposed reduction in U.S. tax rates for U.S. taxpayers to invest in low tax countries or foreign assets generating lightly taxed passive income. The proposed changes will not violate the provisions of existing United States tax treaties.

It is recognized that these appropriate results will be achieved only through imposition of significant new burdens on both taxpayers and the Internal Revenue Service. Computation of a per country limitation with expanded separate baskets will introduce additional complexity into the already complicated limitation calculation. The per country limitation will make determinations regarding the source of subsidiary income, correct intercompany transfer pricing, and expense allocation involving exclusively foreign operations relevant to the foreign tax credit computation. The recordkeeping burdens on taxpayers and auditing burdens on the IRS will be correspondingly increased.

The proposal attempts to minimize these burdens to the extent that can be done consistent with the purpose of the per country limitation. It contains a de minimis rule for resourcing dividends. Simplified expense allocation rules will be considered. The proposal also suggests extending the carryover period, permitting a separate country deduction election, and permitting tax reallocations on an elective basis to limit the potential harshness of the proposal. The Administration will continue to consider other methods of simplifying the credit calculation that are consistent with the objective of limiting the averaging of high and low foreign tax rates. In particular, the Administration will consider workable options for calculating the credit on a regional or integrated operation basis if that can be done in a manner consistent with the underlying rationale of the per country limitation. The Administration has not, however, yet been able to devise an integrated operation approach that both prevents inappropriate averaging and is significantly simpler than a per country approach. In the absence of a workable regional or integrated group proposal, the advantages of the per country limitation are believed to be important enough to warrant the additional complexity and recordkeeping burdens.

The proposed changes to the foreign tax credit other than the per country limitation proposal, i.e. the broadening of the passive income basket, making earnings and profits calculations consistent for all indirect credit purposes, and adopting a pooling approach to making

the relevant earnings calculations under the indirect credit, all have independent merit. They would each make the foreign tax credit mechanism operate more consistently and without unintended harshness to taxpayers or unintended incentives for economically unjustified activities that serve only to increase or accelerate the available credits. Each of these proposals would be beneficial regardless of the method used to calculate the foreign tax credit.

MODIFY SOURCING RULES FOR INCOME AND DEDUCTIONS

General Explanation

Chapter 15.02

Current Law

Rules for defining the source of particular items of income serve two principal purposes. First, those rules define the scope of U.S. taxation of non-resident aliens and foreign corporations, particularly those that do not engage in a U.S. trade or business. Second, through the operation of the foreign tax credit mechanism, the source of income rules define the circumstances under which the United States is willing to concede primary jurisdiction to a foreign country to tax U.S. citizens and residents on income because that income is deemed to be earned in that foreign country. In the respects relevant to the proposals set forth below, existing rules for determining the source of income and the allocation and apportionment of related expenses are as follows:

Income Derived from Purchase and Resale of Property. Income derived from the purchase and resale of personal property, both tangible and intangible, is ordinarily sourced at the location where the sale occurs. The place of sale is generally deemed to be the place where title to the property passes to the purchaser.

Income Derived from Manufacture and Sale of Property. Income derived from the manufacture of products in one country and their sale in a second country is treated as having a divided source. Under existing regulations, half of such income generally is sourced on the basis of the location of the taxpayer's property, reflecting the place of manufacture, and half of the income is sourced on the basis of the place of sale (determined under the title passage test). The division of the income between manufacturing and selling components may be made on the basis of an independent factory price rather than on an arbitrary 50/50 basis if such a price exists.

Income Derived from License of Intangible Property. Royalty income derived from the license of intangible property generally is sourced by reference to the place where the licensed intangible property is used. For certain limited purposes income derived from the sale of intangible property for an amount contingent on the use of the intangible is also sourced as if it were royalty income.

Dividend Income. Dividend income is generally sourced at the place of incorporation of the payor. However, if a U.S. corporation earns more than 80 percent of its income from foreign sources, dividends paid by that corporation are treated as foreign source income.

Interest Income. Interest income is generally sourced on the basis of the residence of the payor. Under one exception to this rule, interest income received from a U.S. corporation which earns more than 80 percent of its income from foreign sources is treated as foreign source income. Certain other exceptions to the source rules applicable to interest income are designed as tax exemptions for limited classes of income earned by foreign persons.

Transportation Income. Under existing regulations income derived from providing transportation services generally is allocated between U.S. and foreign sources in proportion to the expenses incurred in providing the services. Expenses incurred outside the three-mile limit to the territorial waters of the United States are treated as foreign expenses for purposes of this allocation. Special rules apply to income derived from coast-wise shipping and from transportation between the United States and its possessions. Income derived from the lease or disposition of vessels and aircraft that are constructed in the United States and leased to United States persons is treated as U.S. source income. Expenses, losses and deductions incurred in leasing such vessels and aircraft are also attributable to U.S. source income. These rules apply regardless of where the vessel or aircraft may be used.

Allocation and Apportionment of Interest Expense. The determination of taxable income (gross income less expenses) by source or activity requires that expenses be matched with the category of income in question. Under existing regulations, the allocation and apportionment of interest expense to income is based on the principle that money is fungible and that interest expense is attributable to all property of a taxpayer regardless of the specific purpose for incurring the obligation on which interest is paid. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable to attribute part of the cost of borrowing to such other purposes.

Under existing regulations, tax exempt income and assets generating tax exempt income are permitted to be taken into account in allocating deductible interest expense. Interest expense incurred by a related group of corporations that file a consolidated tax return is required to be allocated between domestic and foreign source income in computing foreign source taxable income and the foreign tax credit limitation. Under existing regulations, this allocation is made on a separate company basis, rather than on a consolidated group basis. Thus, a company within the consolidated group that incurs interest expense takes only its own assets and gross income into account in allocating the expense, rather than those of the entire consolidated group.

Reasons for Change

Source of Income

The following basic principles should be applied in formulating rules for determining the source of income. First, appropriate source of income rules should reflect the location of the economic activity generating the income and the source of legal protections facilitating the earning of that income. Income derived from the use of property or capital ordinarily should be sourced where the property or capital is used. Second, the rules should be neutral in the sense that the United States would have no ground for objection if its source of income rules were applied by other countries. Unless there are sufficient reasons to the contrary, international norms for source of income determinations should be followed to the extent such norms exist. Third, the rules should not allow erosion of the legitimate U.S. tax base through taxpayer manipulation of the source rules or of the foreign tax credit limitation. The rules should generally preserve the residence country's taxing right in cases where other countries typically do not assert a source basis claim to tax the income. Fourth, to the extent possible the rules should operate clearly and not require difficult factual determinations on a transaction by transaction basis. Clarity and ease of application would be even more important under the Administration proposal to calculate the foreign tax credit limitation on a per country basis because of the requirement that income be sourced to specific foreign countries.

Plainly, it will not be possible to fully satisfy each of these objectives in every case. Some balancing of the objectives is therefore necessary in reaching appropriate source rules. Existing rules for determining source of income are deficient in the following respects:

Sales Income. Under the existing title passage test, the source of income derived from the sale of goods bears no necessary relationship to the economic activity generating that income. Particularly where property manufactured in the United States is sold to a sales subsidiary abroad, half or more of the income from the sale may be treated as foreign source income even though only a negligible portion of the seller's relevant economic activity may occur outside the United States.

Because the place of title passage may be arbitrarily determined by affected taxpayers, the existing rule permits artificial manipulation of the foreign tax credit limitation and the U.S. tax base. Most foreign countries do not tax sales income merely because title passes in that country. (The United States would not tax such income in the reverse case solely because of U.S. title passage.) The existing U.S. source rule therefore surrenders U.S. primary taxing jurisdiction over sales in many situations where the income is not taxed abroad. Under the foreign tax credit limitation provisions, the zero foreign tax on such income may be averaged with foreign source

income that is highly taxed by a foreign country. This averaging artificially increases the amount of the foreign taxes imposed by a high tax country that may be credited against U.S. tax liability and thereby permits the credit for the foreign tax to reduce U.S. tax otherwise due on income derived from what is essentially domestic economic activity.

Sales of Intangible Property. Income derived from the sale of intangible property generally is determined under a title passage test while income derived from the license of such property is determined by reference to the place where the property is used. Existing rules that treat sales and licenses similarly are limited in their scope. The economic distinction between a sale and a license of intangible property often is elusive. Clarity and uniformity of treatment would be served by applying the same source of income rules to all transactions involving intangible property. The title passage rule is no more satisfactory when applied to sales of intangible property than when it is applied to sales of tangible property. Moreover, the principal factor giving intangible property value is the legal protection afforded that property in the country where it is used, a factor arguing for a source rule based on the place of use in all transactions involving intangible property.

Dividend Income. The existing source rule applicable to dividend income focuses on the place of incorporation of the corporation distributing the dividend income. This rule, or a close variant of it focusing on the corporation's place of management, is followed in the tax systems of most countries. The rule is clear and easily applied and otherwise generally satisfies the characteristics of appropriate source rules.

The exception to this general rule for so-called 80-20 companies alters a sound, well accepted rule under circumstances where most foreign countries do not assert a competing source based claim to tax the income. Because foreign countries normally do not tax such dividends, the treatment of the 80-20 company dividend as foreign source may have the effect of making what would otherwise be excess foreign tax credits usable. This occurs despite the fact that a full foreign tax credit is available with respect to the foreign tax on the 80-20 corporation's operating income. Very often the result will be the total exemption of the 80-20 dividend from shareholder level tax either in the United States or in the country where the earnings were derived. Moreover, foreign taxpayers may be able to use an 80-20 holding company to convert distributions by U.S. operating subsidiaries into foreign source income and thereby avoid U.S. withholding tax on those distributions.

Interest Income. Just as with dividends, the 80-20 exception to the general source rule applicable to interest income alters an accepted rule in the absence of competing source based claims of foreign countries. The 80-20 rule for interest therefore gives rise to the same type of U.S. withholding tax avoidance and total U.S. and

foreign tax exemption as does the dividend rule. Where it is desirable to provide a U.S. tax exemption for specific classes of interest income, that should be done directly rather than through modifications to the source rules.

Transportation Income. Under current rules, large portions of transportation services income are treated as earned in international waters or skies and outside the generally asserted source taxing jurisdiction of any country. Such income may therefore go totally untaxed as a result of the foreign tax credit mechanism. Section 861(e) modifies the general source rule for income and related expenses derived from U.S. produced vessels and aircraft leased to U.S. persons. The general source rule is abandoned solely to provide a very indirect subsidy for users of U.S. produced ships and aircraft by allocating losses on the lease of such ships and aircraft to the United States, so as to avoid a reduction in the foreign tax credit limitation. This subsidy is inappropriate in a system of neutral source rules. An appropriate source rule would reflect the economic activity generating the income.

Allocation and Apportionment of Interest Expense

The current regulation's treatment of a single taxpayer's interest expense under the fungibility approach generally apportions interest expense to income based on the relative value of assets used to generate the income. It also permits allocation on the basis of gross income provided the result does not depart too significantly from the result of an asset based allocation. It is inappropriate, however, to apply the fungibility concept on a separate company basis when a taxpayer is a member of an affiliated group and is included in a consolidated return. The separate company method of allocation enables taxpayers to limit artificially the interest expense allocated to foreign source income by simply manipulating the location of borrowing within the consolidated group. This may result in an unwarranted increase in the amount of foreign tax credit available to a consolidated group of corporations.

The inclusion of tax-exempt interest and assets generating tax exempt interest in the allocation formula has similarly provided opportunities for artificial inflation of the foreign tax credit limitation. The inclusion of exempt U.S. source income and assets in the expense allocation increases the amount of expense allocated to U.S. source income even though the income generated is not subject to U.S. tax. The proposed change complements the Administration proposal to deny deductions to all taxpayers for interest incurred to carry tax-exempt obligations. The change in expense allocation rules would be justified, however, in the absence of a change in the rules relating to deductibility of the expense.

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Proposal

Source of Income

Source Rules Relating to Sales Income. Income derived from the sale of personal property is divided into three broad categories for purposes of determining source: (i) income from sales of inventory-type property in the ordinary course of business; (ii) income from sales of non-inventory property used in a trade or business; and (iii) income from sales of other personal property including personal financial property such as stocks, bonds and commodities contracts. Income derived from the purchase and resale of inventory-type goods will be sourced in the country of the taxpayer's residence. An exception to this general rule will apply if the seller maintains a fixed place of business located outside of its country of residence and that fixed place of business participates materially in the sale generating the income. In such a case, the income would be sourced in the country where the fixed place of business is located. However, all sales to a taxpayer's foreign subsidiaries and affiliates would be sourced at the seller's residence even if the seller maintains a fixed place of business in another country. A fixed place of business maintained by an independent distributor would not be attributed to the seller for purposes of this source rule. The place where title to the goods passes to the buyer, the place where purchasing activity is carried out and the place of ultimate destination of the goods all would be irrelevant for purposes of determining the source of sales income. The proposal modifies the original Treasury Department proposal by requiring only that a foreign fixed place of business participate materially in a sale, rather than conduct the predominant portion of the selling activity, in order to qualify for the exception to the residence based source rule. This change will make the source rule correspond to the principles of existing section 864(c)(4)(B)(iii) and will avoid disputes over the relative contribution to a sale of sales activity conducted in two places of business. It is believed that the Administration proposal will correlate the source of sales income with the location of the underlying selling activity much more closely than does existing law.

Similar changes would also be made in the rules for determining the source of income derived from the manufacture and sale of inventory-type products. The existing practice of sourcing an arbitrary percentage of such income on the basis of the place of manufacture would continue. The remaining portion of the income would be attributed to sales activity and would be sourced on the basis of the rules described in the preceding paragraph. The title passage test would be eliminated. Accordingly, no portion of the income derived from the manufacture of products in the United States and the sale of such products abroad would be sourced in a foreign country unless the seller maintains a fixed place of business in that foreign country and that place of business participates materially in the sale. Similarly, the sale of property manufactured by the taxpayer in the United States to a foreign sales subsidiary or affiliate would

generate no foreign source income. (The sales subsidiary's income would itself be foreign source and, assuming appropriate pricing, would represent the full return to selling activity.)

Current law arbitrarily divides income between manufacturing and sales activities on a 50/50 basis. It is probable that this division overallocates income to selling activity in many cases. The Administration will consider whether a fixed percentage allocation apportioning greater income to manufacturing activity would more appropriately be applied as a general rule to divide the income. The option of applying an independent factory price in allocating divided source income would be retained, however. The special manufacture-sale rules in the existing regulations relating to U.S. possessions would be eliminated and the rule described above would be applied to such sales.

Income derived from sales of personal property used by the taxpayer in its business (including Corn Products type property that would otherwise be passive investment property) would be sourced in the place where the property is used. Income derived from the sale of personal property not described above, including in particular gains derived from the sale of passive investment property such as stock, securities and commodity futures contracts, would be sourced on the basis of the taxpayer's residence.

Income Derived from Sales of Intangible Property. The rules relating to royalty income derived from licenses of intangible property will be retained in their present form. Source rules relating to sales of intangible property will be modified to correspond to the rules relating to licenses. Accordingly, income derived from the sale of intangible property, other than passive investment property, will be sourced on the basis of where the underlying property is to be used.

80-20 Corporation Rules Relating to Interest and Dividends. The 80-20 corporation exceptions to the general source rules applicable to dividend and interest income will be repealed. Thus, dividends received from a domestic corporation earning most of its income outside the United States will be sourced on the basis of the place of incorporation of the corporation paying the dividend. (See Ch. 15.03 for a proposal to repeal the interest and dividend source rules relating to foreign corporations that earn more than half of their income from U.S. sources and to replace those rules with a branch profits tax.) Interest income received from all U.S. residents and domestic corporations will be sourced on the basis of the residence of the payor without looking to the underlying source of the payor's income. Other provisions of the existing source rules relating to interest income that are designed to provide tax exemptions for particular activities will not be repealed but will be restructured as overt exemption provisions in the interest of establishing neutral source rules. Thus, for example, interest paid on deposits in U.S. banks will be treated as U.S. source income but will be exempt from

tax if the interest is paid to a non-resident alien individual or foreign corporation and is not effectively connected with the conduct of a trade or business in the United States.

Transportation Income. Consideration will be given to modifications in the rules relating to transportation income in order to cause those rules to reflect more accurately the underlying economic activity, to more fully exercise U.S. taxing jurisdiction over income not taxed abroad, and to make those rules operate in a manner consistent with a per country foreign tax credit limitation. Specifically, more general application of the 50 percent convention applied to possessions related transportation income will be considered. The special source rule of section 861(e) relating to income derived from the lease or disposition of vessels and aircraft manufactured in the United States will be repealed.

Allocation of Interest Expense

Interest expense incurred by a corporation joining in filing a U.S. consolidated return will be required to be allocated to income from various sources on a consolidated group basis. The assets or gross income of all members of the consolidated group shall be aggregated for purposes of determining the percentage of interest expense to be allocated to foreign income. That percentage will then be applied to the interest expense of each member of the group in calculating the foreign tax credit under the consolidated return regulations. The separate company basis of allocation will be retained for taxpayers not filing a consolidated return.

Only deductible expenses are required to be allocated between foreign and domestic sources in calculating net taxable income from foreign sources. In order to reach the proper result when a portion of a taxpayer's interest expense is not deductible because it is incurred to carry tax exempt obligations, tax exempt interest income and assets generating tax exemp't interest income will not be considered in allocating interest expense to foreign source income for purposes of the foreign tax credit calculation.

Effective Dates

The proposals would generally be effective for taxable years beginning on or after January 1, 1986. The modification of the source rule for interest income received from 80-20 corporations would be effective only with respect to interest paid on debt obligations incurred after January 1, 1986. The repeal of the section 861(e) source rule would not affect income derived by the taxpayer owning the asset on January 1, 1986, from the lease or disposition of ships or aircraft first leased by the taxpayer prior to January 1, 1986. Transitional rules applicable to the sales income source rules would be provided for sales made under unrelated party contracts entered into prior to January 1, 1986. The rules relating to the consideration for expense allocation purposes of tax-exempt interest

and tax exempt obligations would not apply to obligations or income derived from obligations held by the taxpayer prior to January 1, 1986.

Analysis

The proposals would create a set of rules for determining the source of income that more clearly reflects the situs of relevant economic activity than do the existing rules. The proposals regarding the source of sales income and the source of interest and dividends paid by 80/20 companies would also limit the circumstances in which the United States cedes its primary tax jurisdiction by treating income that is not ordinarily taxed by foreign countries as foreign source income for U.S. tax purposes. These rules will therefore appropriately restrict the ability of U.S. taxpayers to average down high foreign tax rate income and to use foreign tax credits to offset U.S. tax on income derived from domestic economic activity. The source rule proposals are meritorious without reference to the Administration proposals regarding the foreign tax credit limitation. However, they also complement the proposed modifications of the foreign tax credit limitation and provide rules more suitable to separate country sourcing of income and to the computation of the foreign tax credit limitation on a per country basis.

It can be anticipated that under these proposals somewhat greater amounts of income of U.S. taxpayers derived from sales of products to destinations located outside the United States would be treated in the future as domestic source income. As a result some U.S. export activities would lose collateral foreign tax credit benefits if the exporting companies have excess foreign tax credits from their purely foreign activities. However, the United States should retain the primary taxing right over export income when the activities giving rise to the income are carried out in the United States and should not be granting foreign tax credits with respect to broad classes of income not generally taxed abroad. To the extent export subsidies are included in the tax law they should be overt and evenly applied.

REPLACE SECOND DIVIDEND AND INTEREST TAXES WITH BRANCH-LEVEL TAX

General Explanation

Chapter 15.03

Current Law

The effectively connected income of a U.S. branch of a foreign corporation is subject to U.S. income tax, but there is no additional tax, comparable to the withholding tax imposed on dividends paid by a U.S. subsidiary of a foreign corporation, on the branch's remittances to the home office. Instead, the United States imposes a withholding tax, known as the "second dividend tax," on a proportionate part of the dividends paid by the foreign corporation, if more than 50 percent of the corporation's gross income is effectively connected with a U.S. trade or business.

There is also no tax, comparable to the withholding tax on interest paid to foreign persons by a U.S. subsidiary of a foreign corporation, on the interest paid to foreign persons on debt allocable to the branch. Instead, the United States imposes a withholding tax, known as the "second interest tax," on a proportionate part of the interest paid by the foreign corporation to foreign persons, if more than 50 percent of the corporation's gross income is effectively connected with a U.S. trade or business.

Reasons for Change

A U.S. corporation owned by nonresidents is subject to income tax on its profits, and, in addition, its foreign shareholders are subject to a withholding tax on the dividends which they receive (30 percent by statute, reduced to as little as five percent by treaty). No comparable tax, beyond the corporate tax, is imposed on the distributed profits of a U.S. branch of a foreign corporation. The "second dividend tax" is intended as the analogue to the dividend withholding tax, but it fails to equalize the tax treatment of branches and subsidiaries in many cases. The "second dividend tax" applies only when a majority of the income of the foreign corporation is derived from its U.S. branches, while the dividend withholding tax applies to all distributions of subsidiary profits. Moreover, the enforcement of this tax is very difficult. It is difficult to know when the tax is due and difficult to enforce its collection by a foreign corporation.

Foreign holders of debt of a U.S. corporation owned by nonresidents are subject to a tax on the interest which they receive (30 percent by statute, unless reduced or eliminated by treaty), although for debt issued after July 18, 1984 this tax applies to a limited class of interest. No comparable tax is imposed on the interest paid on debt allocable to the branch. The "second interest tax" is

intended as the analogue to the interest withholding tax, but it also fails to equalize the treatment of branches and subsidiaries in many cases. Like the "second dividend tax," the "second interest tax" applies only when a majority of the income of the foreign corporation is derived from its U.S. branches, while the interest withholding tax applies generally to all interest paid by the subsidiary (except where the interest is exempt by statute or treaty). The "second interest tax" suffers from the same enforcement problems as the "second dividend tax."

Proposal

The "second dividend tax" and "second interest tax" would be repealed and replaced by an additional tax on the profits of U.S. branches of foreign corporations and on interest on (i) debt issued by a foreign corporation to an affiliate which is allocable to a U.S. branch of the corporation and (ii) extensions of credit by a foreign bank to a foreign corporation which is allocable to a U.S. branch of the corporation. The branch-level tax would place the branch of a foreign corporation on a more comparable footing with a U.S. subsidiary of a foreign corporation.

The profits subject to the tax would be defined so as to approximate the distributed profits of a U.S. subsidiary. The taxable income of the branch as shown on its U.S. corporate tax return would be reduced by the U.S. corporate tax before foreign tax credits and by further adjustment to reflect reinvestment of profits in the branch. To adjust for such reinvestment, increases in net investment in the branch, for both fixed and working capital, would be deducted from the after-corporate tax branch profits and increases in net liabilities incurred for such reinvestment would be added to such profits. The addition of increases in net liabilities to taxable profits would ensure that branches could not decrease their branch-level tax through the purchase of assets with debt rather than reinvested earnings. A deficit in taxable profits could not be carried forward or back to other taxable years.

Since the branch-level tax would in part replace the "second interest tax," which is a withholding tax on gross amounts of interest, the interest subject to the branch-level tax would be the gross amount of interest on (i) debt issued by a foreign corporation to an affiliate which is allocable to its U.S. branch and (ii) extensions of credit by a foreign bank to a foreign corporation which are allocable to a U.S. branch of the corporation.

The rate of the branch-level tax would be the same as the dividend and interest withholding tax rates, currently 30 percent. Where the foreign corporation is resident in a treaty country, the treaty rate applicable to direct investment dividends would apply to the taxable profits and taxable interest (if such rate would otherwise be available to the foreign corporation under the treaty).

The same rule for determining what debt of a foreign corporation is allocable to its U.S. branch would apply for purposes of the branch-level tax as for determining allowable interest deductions for purposes of the corporate income tax.

All foreign corporations with a branch in the United States (a trade or business under the tax code or a permanent establishment under tax treaties) would be subject to the branch-level tax, unless it is prohibited by an existing U.S. tax treaty. The tax would not override existing treaties, but the Treasury Department would seek to amend those treaties which now prohibit the tax to permit its imposition. (Many treaties do not prohibit the imposition of such a tax.)

Effective Date

The proposal would take effect for taxable years beginning on or after January 1, 1986.

Analysis

Under the proposal, U.S. tax would apply more evenly to foreign corporations doing business in the United States than under present law. Thus, the tax rules would have less of an influence on a foreign investor's decision whether to operate in the United States through a branch or a subsidiary. (Under current law a branch operation is generally subject to lower U.S. taxes than a subsidiary, if the subsidiary pays dividends.) The branch-level tax is also more easily administrable and enforceable than the "second dividend tax" and "second interest tax." It can be reported on the regular corporate income tax form of the branch. Many foreign countries, including Canada, France, and Australia, impose a branch profits or remittance tax.

There may be situations under bilateral income tax treaties with other countries where the availability of a dividends-paid deduction to a U.S. subsidiary of a company resident in the treaty country will result in heavier U.S. taxation of income earned through a U.S. branch of such company than through a subsidiary. In that event, consideration might be given to granting comparable corporate tax relief to branches of companies resident in the other country in the context of bilateral treaty negotiations.

The proposed changes are not likely to have a significant effect on flows of capital into the United States. The latest available data indicate that most foreign corporations operating in the United States through branches are in the finance, insurance and real estate industries, with most of the income attributable to branch banks.

REVISE TAXATION OF FOREIGN EXCHANGE GAINS AND LOSSES

General Explanation

Chapter 15.04

Current Law

Foreign Currency Transactions

Recognition of Income. Foreign currency is treated as property for Federal income tax purposes. Generally, exchange gain or loss is recognized when payment is made on a foreign-currency-denominated obligation. However, the recognition of loss on a forward exchange contract or other foreign-currency-denominated position in actively traded personal property that substantially diminishes a taxpayer's risk of loss with respect to another such position is subject to the taxing regime for straddles. Further, certain foreign currency forward contracts are marked-to-market on the last day of a taxpayer's taxable year.

It is uncertain how the original issue discount rules (providing for the accrual of discount income) are to apply to foreign-currency-denominated obligations issued for foreign currency. If foreign currency is treated as property, the recently enacted imputed interest rules applicable to debt instruments issued for property would apply (unless the obligation is traded on an established securities market). Generally, these rules would impute interest on foreign currency loans at 120 percent of the "applicable Federal rate" whenever the stated interest rate was equal to or less than 110 percent of the applicable Federal rate. This would have the effect of treating the loan as though it were translated to U.S. dollars on the date made and recharacterizing payments as interest based on dollar interest rates. The General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee on Taxation, states that Congress did not intend for the imputed interest rules to apply to foreign currency loans where the value of the currency is readily ascertainable by reason of active trading in an established market. If the issue price were determined with reference to the current value of an actively traded foreign currency, however, original issue discount generally would only be found where the stated interest rate in the foreign currency is less than the arm's length interest rate in the foreign currency.

The Secretary is granted broad regulatory authority to modify the original issue discount rules as necessary to carry out the purposes of the original issue discount provisions. The General Explanation provides that such regulations should deal with treatment of foreign-currency-denominated obligations issued for property.

Character and Source. Because foreign currency is treated as property, the full panoply of rules pertaining to characterization of gain and loss as capital or ordinary applies. There is great uncertainty under the relevant judicial decisions as to the proper characterization of exchange gain or loss. Moreover, foreign currency forward contracts held as capital assets are marked-to-market and gain or loss is treated as 60 percent long-term and 40 percent short-term capital gain or loss. Straddles consisting of such contracts and foreign-currency-denominated positions are subject to the mixed straddle rules.

Furthermore, there is little authority under current law regarding the source of foreign exchange gain and the proper allocation of foreign exchange loss. Because foreign currency is treated as property, the source of exchange gain has been determined under the passage of title test applied to source gain from the sale of personal property. This test is extremely difficult to apply to international transactions involving foreign currency.

Foreign Currency Translation

Income and loss of a taxpayer for Federal income tax purposes is determined in U.S. dollars. (References herein to dollars are to the U.S. dollar.) While taxpayers are permitted to keep books and records in a foreign currency under current law, there are no clear standards for when this is appropriate. Taxpayers that maintain books and records in a currency other than the dollar have been permitted to use a variety of methods to translate results recorded in a foreign currency into dollars.

Foreign Branch of a Domestic Corporation. A domestic taxpayer that maintains books and records of a foreign branch in a foreign currency may report income or loss of the branch using either the "net worth" or the "profit and loss" method of currency translation. Under the net worth method, the dollar value of the income or loss of the branch is measured by adding the increase (or decrease) in the dollar value of the branch net worth and the dollar value of any remittances from the branch to the home office. For purposes of determining the dollar value of the branch net worth at the beginning and end of each period, current assets and liabilities are translated at the year-end exchange rates, and non-current assets and liabilities are translated at the exchange rate for the date acquired or incurred. Remittances are translated at the exchange rate on the date remitted. No specific rules govern the source or character of income of a net worth branch. The net worth method causes exchange gain or loss on unrealized income or loss to be taken into account currently.

Under the profit and loss method, only the profit or loss of the branch, determined in the foreign currency, is translated into dollars. Unremitted profits are translated at the year-end exchange rate and remittances are translated at the exchange rate on the date made. There are no clear rules for translating losses, or for

determining the character or source of remittances from a profit and loss branch. The profit and loss method results in the recognition of exchange gain or loss only with respect to income or loss that has been realized in the foreign currency.

Foreign Corporations. A domestic taxpayer that conducts foreign operations through a foreign corporation is subject to U.S. tax on actual distributions of earnings of the foreign corporation or on deemed distributions from a controlled foreign corporation that are included in a U.S. shareholder's income under subpart F of the Code. In addition, gain realized by a domestic taxpayer on the sale of stock of a controlled foreign corporation may be recharacterized as a dividend to the extent of the untaxed earnings of the foreign corporation. A domestic corporate shareholder that owns 10 percent or more of the voting stock of a foreign corporation generally will be allowed a foreign tax credit for taxes paid by the foreign corporation with respect to earnings distributed as a dividend, or as a deemed distribution under subpart F or in connection with a sale of stock in the corporation (the indirect credit).

The rules for translating into dollars earnings of a foreign corporation that maintains its books and records in a foreign currency depend on how the earnings are subjected to U.S. tax. An actual distribution is translated into dollars at the exchange rate for the date received. In determining the indirect credit with respect to an actual distribution that is a dividend, the dividend, accumulated profits and foreign tax deemed paid with respect to the dividend are translated at the exchange rate for the date the distribution is received by the taxpayer. (The translation of distributions for dividend and indirect credit purposes at a current exchange rate was endorsed in Bon Ami Company, 39 B.T.A. 825 (1939), a decision of the predecessor to the Tax Court, and is referred to herein as the Bon Ami approach.)

If a domestic corporation is considered to receive a deemed distribution of earnings of a foreign subsidiary under subpart F, the amount of the distribution and the earnings to which the distribution is attributable are translated to dollars under rules which (i) translate the profit and loss to dollars at an average exchange rate for the period, and (ii) increase or decrease the dollar profit or loss amount by an additional exchange gain or loss reflecting a translation of the balance sheet of the corporation (the subpart F method). Transactions in dollars are reflected at their dollar amount. The foreign tax deemed paid is translated at an average exchange rate for the period in which the income is earned.

Income Taxes Available for the Foreign Tax Credit. For purposes of the direct credit, cash basis taxpayers translate the amount of foreign income taxes paid into dollars at the exchange rate for the date of payment. Accrual basis taxpayers use the year-end rate for the year of accrual or, if paid during the year, the exchange rate for the date of payment. Accrued taxes paid in a later year must be restated to the value on the date of payment.

For purposes of the indirect credit, foreign taxes deemed paid with respect to an actual distribution are translated to dollars at the exchange rate for the date the distribution is received. Foreign taxes deemed paid with respect to income inclusions under subpart F are translated at an average rate for the period in which the income is earned by the foreign corporation.

Reasons for Change

The various rules for taxing foreign currency transactions of a dollar taxpayer and for translating into dollars the income and loss of a foreign branch or corporation that maintains its books and records in a foreign currency have never been rationalized. In 1980 the Treasury Department conducted a comprehensive review of the law pertaining to taxation of foreign currency. That review resulted in a discussion draft presenting a system for taxing foreign exchange gains and losses (the Discussion Draft) that reflected the "functional currency" foreign currency translation principles proposed in an exposure draft by the Financial Accounting Standards Board (later published as FASB, Statement No. 52: Foreign Currency Translation (1981)). The functional currency concept is based on the proposition that the most meaningful measurement unit for assets, liabilities and operations of an entity is the currency in which it primarily conducts its business.

The Administration proposals generally follow the Discussion Draft and adopt the functional currency concept for determining when an entity must subject transactions in a foreign currency to the tax rules for foreign currency transactions. Conversely, the functional currency concept would be used to determine when an entity would be allowed to maintain its books and records in a foreign currency, for Federal income tax purposes, and account for transactions in the foreign currency as though that currency were the dollar (and the dollar were a foreign currency).

Foreign Currency Transactions

The Internal Revenue Code and Treasury regulations provide little direct guidance regarding the taxation of gain or loss from transactions in a foreign currency. The administrative and judicial decisions have failed to enunciate a clear or consistent set of rules; moreover, they do not take account of changes in the law relating to the time value of money, straddles and mark-to-market taxation of certain property. Finally, innovations in the financial markets have rendered even existing tax rules anachronistic. The result is uncertainty of tax treatment for many legitimate business transactions and opportunities for abuse and whipsawing of the fisc.

A significant defect of the current tax treatment of foreign currency transactions is its failure to reflect the underlying economic relationship of exchange rate fluctuations to interest.

Generally, exchange rate fluctuations will tend to offset interest rate differences between two currencies. The relationship between interest rates for a particular currency and expected movements in exchange rates is not perfect, because of different risk factors associated with different currencies. In addition, international currency markets are not perfectly efficient, particularly for less actively traded currencies. However, the relationship between interest rates in two currencies and expected exchange rates is quite close for those traded currencies in which the preponderant amount of international commercial transactions are conducted. The failure of current law to reflect this underlying economic reality gives rise to the same kinds of mismatching of income and deductions and manipulation of the principal amount of indebtedness that caused enactment of the original issue discount provisions of current law.

For example, assume that a dollar taxpayer sells property in exchange for an obligation denominated in Swiss francs bearing interest at a market rate for francs of 5 percent when the dollar interest rate on an obligation of the same maturity for a comparable borrower would be 10 percent. While the lender will earn interest income at a 5 percent rate in francs, he will generally expect the franc to appreciate in value over the term of the obligation so that he can buy sufficient additional dollars to bring his overall yield on the obligation up to a return equivalent to that which he could have earned by purchasing a comparable dollar obligation. In this circumstance the true interest element of the transaction generally would be understated and the principal component overstated. This may occur without regard to whether there is original issue discount in terms of the market interest rate for the foreign currency.

Alternatively, assume that a dollar taxpayer issues an obligation denominated in Brazilian cruzeiros bearing interest at a market interest rate for cruzeiros of 32 percent when the comparable dollar rate is 10 percent. While the borrower will accrue interest expense based on the 32 percent rate in cruzeiros, he will expect the cruzeiro to depreciate in value over the term of the obligation so that his true cost of borrowing will not exceed the rate at which he could borrow in dollars. If the anticipated exchange loss is not accrued, his true interest expense will be overstated. While recently enacted time value of money legislation authorizes regulations that would provide for correct timing of recognition of anticipated exchange gain or loss, it would be preferable to establish a coherent set of tax rules for foreign currency transactions.

A second defect of current law is the extreme uncertainty of application of rules to determine the character and source of income. At least one U.S. Court of Appeals has held that foreign exchange gain on the repayment of a taxpayer's foreign-currency-denominated obligation is the equivalent of cancellation of indebtedness income. (Some taxpayers argue that such gain is eligible for deferral from current tax if the taxpayer elects to decrease basis in certain depreciable assets.) Other case law suggests that exchange gain with

respect to a foreign-currency-denominated obligation that is a capital asset in the hands of a taxpayer would be capital gain. The inconsistent authority has created uncertainty. The same U.S. Court of Appeals referred to above also affirmed a divided Tax Court decision holding that an exchange loss on repayment of a foreign-currency-denominated loan is ordinary in character because the repayment of a loan does not constitute a sale or exchange. Treatment of exchange gain as cancellation of indebtedness income and exchange loss as ordinary loss affords opportunity for tax avoidance.

Foreign Currency Translation

Under current law, there are no clear standards for determining when books and records for a branch (or a controlled foreign corporation) may be maintained for Federal income tax purposes in a foreign currency. This is significant because if transactions are accounted for in the local currency, exchange gain and loss (in relation to the dollar) will not be recognized with respect to individual transactions at the time income or loss is realized. Instead, under the net worth, profit and loss or subpart F methods, exchange gain or loss is determined in different ways for the aggregate results of the reporting entity for the taxable year. The distinction in treatment that results from use of one of the net translation methods instead of translating separate transactions requires that standards be provided to ensure that income in dollars is clearly reflected.

Foreign Branch of a Domestic Corporation. The use of the net worth method for foreign branches under current law generally allows exchange gain or loss on net current assets to be taken into income currently even though income from the disposition of the assets has not been realized. The subpart F method produces a similar result for controlled foreign corporations. Therefore, in the case of a controlled foreign corporation a taxpayer may in effect elect to recognize foreign exchange loss (or gain) currently by realizing subpart F income in a corporation operating in a weak (or strong) currency. The recognition of exchange loss (or gain) on unrealized income may have the effect of overstating (or understating) the indirect foreign tax credit.

In a world of flexible exchange rates, it is inappropriate for a taxpayer operating primarily in a foreign currency to accelerate recognition of foreign exchange gain or loss if the underlying income or loss is not realized or property is not taken out of use in the foreign currency environment. In this regard, the profit and loss method is more consistent with the functional currency concept than is the net worth or subpart F method.

Foreign Corporations. The virtues of the Bon Ami approach are its relative simplicity and that it maintains the relationship between the dollar value of a dividend grossed-up for foreign taxes and the foreign taxes deemed paid with respect to the earnings. The Bon Ami approach, however, has significant defects. First, even if there is a

distribution of the current year's earnings, the date of distribution translation rate under Bon Ami generally will differ from the average exchange rate used under the subpart F method. A taxpayer therefore may "trigger" a deemed distribution of those earnings under subpart F and obtain a different result. The inconsistency in translation of income and foreign tax paid between an actual distribution and a subpart F distribution (and the results if the income is earned through a branch) is more dramatic if earnings are not distributed currently.

For example, assume that a foreign corporation earns 100 Swiss francs and pays Swiss tax of 40 francs when the exchange rate is four Swiss francs to the dollar. (In dollars, pre-tax earnings would be $25 and the Swiss tax $10.) If these earnings are distributed in a later year when the Swiss franc has appreciated to two francs to the dollar, the dividend (grossed-up for foreign taxes paid) would be $50 and the deemed paid taxes would be $20. Similarly, if the franc declined to eight francs to the dollar, the grossed-up dividend would be $12.50 and the deemed paid Swiss tax $5.

As may be seen from the example, the exchange rate gain or loss between the date the income is earned and the date it is paid is in effect characterized as an increase or decrease in the earnings of the foreign corporation. In addition, the deemed paid foreign tax is increased or decreased by subsequent exchange fluctuations even though the tax may actually have been paid in an earlier year. Treating the exchange gain or loss as part of the distribution and translating the deemed paid foreign tax at the current rate distorts the amount of allowable foreign tax credits. Moreover, it gives rise to a different result than would occur if the same income were subpart F income or were earned through a branch and remitted to the head office at a later date.

Proposal

Functional Currency of an Entity

Each business entity of the taxpayer would have a single functional currency. For this purpose, a business entity would be any separate and distinct business operation of the taxpayer, the activities of which constitute an active trade or business and are accounted for by a complete and separate set of books and records. Each taxpayer always will be a business entity separate from any affiliated taxpayer, though a single taxpayer may include more than one business entity. (A business entity is hereinafter referred to as an entity.)

The functional currency of an entity generally would be the primary currency of the economic environment in which the entity operates. Thus, most U.S. taxpayers operating in the United States would use the dollar as their functional currency. A taxpayer always would be allowed to elect to treat the dollar as the functional

currency of an entity. (An entity whose functional currency is the dollar is referred to herein as a dollar taxpayer.) The Administration is considering whether special rules should be applied with respect to taxpayers operating in a highly inflationary economy.

If a taxpayer does not elect to use the dollar as the functional currency for an entity, the entity's functional currency generally would be the currency of the country in which the entity is located and the books and records maintained. However, the identification of a foreign functional currency of an entity would be a question of fact to be determined on the basis of the relevant facts and circumstances. Factors to be taken into account would include:

(i) the currency in which the books of account of the entity are maintained;

(ii) the currency in which the revenues and expenses of the entity are primarily generated;

(iii) the currency in which the entity primarily borrows and lends; and

(iv) the functional currency of related entities and the extent of integration of the operations of related entities.

These factors generally correspond to the factors relevant for determination of a functional currency required for financial accounting purposes under FASB Statement No. 52. While the functional currency of an entity generally would correspond to that for financial accounting purposes, it is not necessary that it do so. (Moreover, a "business entity" for tax purposes will not necessarily comprise the same activities as a reporting enterprise for financial accounting purposes.)

Although identification of a functional currency would depend on the facts and circumstances relevant to each entity, consistent criteria for identifying the functional currency of entities conducting similar trades or businesses in different countries would be required. If in a particular case the facts and circumstances did not indicate choice of a particular currency, taxpayers would have discretion in choosing a functional currency from among the possible alternatives. A consistent choice would have to be made for similarly situated entities. The choice of a functional currency for an entity, including an election to use the dollar as the functional currency, would be treated as a method of accounting which may be changed only with the consent of the Secretary.

The choice of a functional currency is significant because it will determine the circumstances in which exchange gain or loss will be recognized. If an entity adopts a functional currency other than the dollar, the entity would be required to maintain books and records for Federal income tax purposes in the functional currency. Transactions

in the functional currency would not be subject to the taxing rules for foreign currency transactions. However, if the entity conducts transactions in a currency other than its functional currency, exchange gain or loss (in relation to the functional currency) would be recognized under the rules for foreign currency transactions.

For example, if an entity that uses the French franc as its functional currency promises to pay francs in six months in exchange for property, exchange gain or loss would not be realized upon payment (without regard to whether the value of the franc had changed in relation to the dollar). Instead, the income or loss from the transaction would be included as part of the entity's profit or loss for the period. The entity's profit and loss (in francs) would be translated under the proposals for foreign currency translation. However, the entity's exchange gain or loss from transactions in currencies other than the franc (including the dollar) would be taxed under the proposals for foreign currency transactions.

Foreign Currency Transactions

This section describes rules for the taxation of transactions in a currency other than the entity's functional currency. For ease of exposition, it is assumed that the entity's functional currency is the dollar and that the transaction is denominated in a foreign currency.

Recognition of Income. Exchange gain or loss would not be realized with respect to a foreign-currency-denominated item of income or expense that is received and translated on the same date as it is recognized as income or allowed as a deduction for Federal income tax purposes. For example, if an entity sells property for Swiss francs and receives the francs on the date the sales income is taken into account for tax purposes, no exchange gain or loss will arise since the item of income is translated on the same date as the income is recognized for tax purposes. Thus, exchange gain or loss does not arise in a broad range of everyday transactions. Moreover, if in the foregoing example the entity's functional currency is the Swiss franc, the entity would not be required to recognize exchange gain or loss on a transaction in francs but would translate the results of its operations for the period under the profit and loss method.

Foreign exchange gain or loss may arise with respect to a foreign-currency-denominated financial asset or liability. A foreign-currency-denominated financial asset or liability is any financial asset or liability (e.g. trade receivables or payables, preferred stock and debt instruments) the principal amount of which is determined in one or more foreign currencies. If there is a change in the exchange rate between the date on which a foreign-currency-denominated asset is taken into account for tax purposes (i.e. recorded as an item of income or expense, treated as a liability or assigned an asset basis) and the date it is paid, foreign exchange gain or loss will exist.

Exchange gain or loss with respect to financial assets or liabilities denominated in a currency other than the functional currency of an entity may properly be thought of as an economic equivalent to interest. In most transactions the parties anticipate that exchange gain or loss with respect to a foreign-currency-denominated financial asset generally will offset the difference between the yield in the foreign currency and the yield for a comparable dollar asset over the life of the asset. It is therefore appropriate to treat foreign exchange gain or loss as the equivalent of interest for tax purposes.

In order to prevent the mismatching of income and deductions that can arise if foreign exchange gain or loss is not taken into account until it is realized, "anticipated exchange gain or loss" would be recognized on an accrual basis with respect to a foreign-currency-denominated financial asset or liability that provides for a fixed or determinable payment in the future (e.g., an accrued item of income or expense, or an obligation). Anticipated exchange gain or loss would be determined under rules comparable to those which apply to impute interest with respect to obligations issued for property. Unanticipated exchange gains and losses would be recognized when realized.

Anticipated currency gain or loss would be based on the difference between the nominal dollar yield on the asset or liability and the applicable Federal rate with respect to an equivalent dollar-denominated asset or liability. The nominal dollar yield of the asset may be measured by translating the principal amount and future payments on the asset into dollars at the exchange rate on the date incurred and calculating the yield using those amounts. The anticipated exchange gain or loss would equal that amount which would increase or decrease the nominal dollar yield to the market dollar yield. (If the functional currency is not the dollar, the anticipated exchange gain or loss with respect to a transaction in a currency other than the functional currency would be based on the difference between the nominal yield and the market yield in the functional currency.) The accrual of anticipated exchange gain would increase the holder's basis in the obligation; the accrual of anticipated exchange loss would decrease basis in the obligation.

It is recognized that the proposed treatment of foreign exchange gains and losses would raise the complexities similar to those existing today in connection with the rules applicable to dollar obligations issued for property. The Administration will consider whether it is possible to establish safe harbors for circumstances where the mismatching of income and expense would not be material.

Character and Source. Anticipated and unanticipated exchange gain or loss generally would be treated as an increase or decrease in interest income or expense with respect to the foreign-currency-denominated asset or liability. However, if exchange gains exceed interest expense, such gains would be treated as additional interest

income. If exchange losses exceed interest income, such losses will be treated as additional interest expense. Exchange gains will be sourced under the same rules as apply to interest income. Exchange losses would be allocated and apportioned under the same rules as apply to interest expense.

Forward Exchange Contracts. This subsection describes rules for the taxation of gain or loss on a forward sale or purchase contract, or a contract to receive or pay dollars or a foreign currency, that hedges a specific foreign-currency-denominated asset or liability (including an item of income or expense). For this purpose, a forward sale contract is any contract to sell or exchange foreign currency at a future date under terms fixed in the contract. A forward purchase contract is any contract to purchase foreign currency with dollars at a future date under terms fixed in the contract. A contract to exchange foreign currency for another foreign currency at a future date under terms fixed in the contract would be considered a forward sale contract.

A contract will be considered to hedge a foreign-currency-denominated item if (i) the item hedged would constitute ordinary income or expense to the taxpayer, (ii) the primary purpose of the contract (either alone or in combination with other contracts) is to offset the effect of a change in the exchange rate on the dollar value of the foreign-currency-denominated item, and (iii) either the taxpayer identifies the contract(s) as hedging a particular item or the Commissioner determines that, under the facts and circumstances, the contract hedges a particular item. For this purpose, a contract offsetting risk of exchange fluctuations on the value of stock in a non-consolidated subsidiary or of assets held by, or liabilities of, a non-consolidated subsidiary would not be considered a hedge.

The exchange gain or loss on a forward sale contract hedging the principal amount of a foreign-currency-denominated financial asset would be recognized on an accrual basis and would be treated as in increase or decrease in the interest received with respect to the asset. The exchange gain or loss on a forward purchase contract hedging the principal amount of a foreign-currency-denominated financial liability would be characterized and sourced in the same manner as interest paid with respect to that liability. The gain or loss on a forward sale or purchase contract hedging, respectively, an item of income or expense would be characterized and sourced in the same manner as an increase or decrease in the item of income or expense. Comparable rules would also apply to contracts for payments made to offset foreign exchange fluctuations.

Foreign Currency Translation

Foreign Branches. An entity that uses a functional currency other than the dollar would be required to use a profit and loss method to translate income or loss into dollars at the average exchange rate for the period. For example, if an entity using the Swiss franc as its

functional currency earned 10,000 Swiss francs and made no remittances to the home office during the period, and if the average exchange rate for the period was 4 francs to the dollar, the profit of the entity would be $2,500.

It is necessary to establish rules for translation of losses and to account for exchange gain or loss with respect to property that is transferred to and from an entity of the taxpayer having a different functional currency, in order to ensure that the cumulative gain or loss recognized over the life of the entity is the same without regard to its functional currency. If translation rules are not provided for losses and remittances, exchange gain or loss with respect to assets acquired with income or capital of the entity might never be recognized.

A taxpayer using the dollar as its functional currency would be considered to have a dollar (i.e. functional currency) "basis" in an entity solely for purposes of recognition of exchange gain or loss. The taxpayer's dollar basis in the entity would be analogous to a partner's basis in a partnership interest; it would identify when exchange gain or loss should be recognized with respect to distributions and losses. The basis in the entity would be increased by contributed property translated on the date of contribution and by unremitted earnings translated at the average exchange rate for the year. Losses translated at the average rate for the year and remittances translated at the exchange rate for the date remitted would reduce entity basis. Exchange gain and loss on remittances would be recognized once entity basis is recovered. Exchange gain or loss realized on remittances of property would be treated as ordinary and domestic source income.

For example, assume that a dollar taxpayer's head office contributes 200 Swiss francs to an entity using the Swiss franc as its functional currency when the exchange rate is four francs to the dollar. The entity earns 100 francs during a period in which the exchange rate does not change. At the end of the period, the entity's profit would be $25 and the taxpayer's dollar basis in the entity would be $75 ($50 + $25 = $75). If the entity loses 40 francs the following year when the exchange rate is two francs to the dollar, the loss would be $20 and the entity basis would be $55 ($75 - $20 = $55). No exchange gain or loss would be required to be recognized during that year. If the entity were liquidated after the end of the second year and the remaining 260 francs were remitted when the exchange rate remained at two francs to the dollar, the difference between the value of the francs on the date of remittance and the branch basis would be treated as exchange gain or loss. In this case there would be exchange gain of $75 ($130 - $55 = $75). The exchange gain would be treated as ordinary and domestic source income.

Foreign Corporations. As described in Ch. 15.01, the Administration proposes that the indirect tax credit be computed using a "pooling" concept. That is, dividend distributions and subpart F

income inclusions will be considered made from the pool of all of the distributing corporation's earnings and profits. For translation purposes, it is tentatively proposed that the Bon Ami approach be followed. Accordingly, an actual distribution, the pool of earnings and profits from which the distribution derives and the foreign taxes deemed paid with respect to such earnings would be translated at the exchange rate for the date of distribution. Amounts deemed distributed under subpart F, the pool of earnings from which the deemed distribution derives and the deemed paid taxes would be translated at the average exchange rate for the year in which the subpart F income is earned. Earnings previously taxed under subpart F would be segregated in a separate pool. When such earnings are later actually distributed, any further exchange gain or loss on the distribution would be treated as ordinary and domestic source income or loss. The exchange gain or loss would be measured by multiplying the foreign currency distribution by the difference between the exchange rate for the date of the deemed distribution and the exchange rate on the date of actual distribution.

Because of the concerns described above with respect to the Bon Ami approach, the Administration is continuing to consider an alternative approach which would separate the exchange gain or loss from the value of an actual distribution at the time it was earned. Under this approach, the grossed-up dividend distribution would be translated at the historic exchange rates applicable to the earnings from which the distribution is derived. Any subsequent exchange gain or loss with respect to the actual distribution (which would not include the gross-up for the foreign taxes deemed paid) would be recognized at the time of the distribution. Such an approach would reduce the disparity in treatment of exchange gain and loss between actual and deemed distributions and between income earned by foreign branches of domestic corporations and foreign corporations.

Other Translation Matters. The average exchange rate for a period is a rate which, if used to translate total gross receipts of an entity during the period, would produce approximately the same dollar amount as would have been obtained had each gross receipt of the entity been translated at the exchange rate for the date the receipt was recorded for tax purposes. A taxpayer would be permitted to use any reasonable procedure, consistently applied, to determine an appropriately weighted exchange rate for the period.

If an entity or foreign corporation uses one currency as its functional currency and maintains books or records in another currency or conducts transactions in another currency, results in the other currency would be translated into the functional currency before translation into dollars.

The amount of foreign income taxes claimed as a credit would be restated to take account of any refund or difference between the amount accrued and the amount paid. The restated foreign tax,

however, would be translated at the same rate as applied to the tax which was originally taken into account for Federal income tax purposes.

Effective Dates

The proposals would be effective for taxable years beginning on or after January 1, 1986. The proposals governing taxation of foreign currency transactions would be effective for foreign-currency-denominated assets acquired or liabilities incurred after January 1, 1986.

Analysis

The proposals would rationalize the taxation of foreign exchange transactions by (i) providing rules to identify a taxpayer's functional currency, (ii) treating exchange gain or loss on assets or liabilities not denominated in a functional currency as the equivalent of interest, (iii) taxing anticipated exchange gain or loss on an accrual basis, and (iv) providing clear and unambiguous character and source rules for anticipated and unanticipated exchange gain and loss. The treatment of exchange gain or loss as interest and subjecting anticipated exchange gain or loss to tax on an accrual basis takes account of the economic relationship between exchange rate fluctuations and interest rates. Accrual taxation would prevent overstatement of deductions for borrowings in weak currencies and understatement of income with respect to loans in strong currencies. The former, in particular, has been the basis for a number of tax shelters. The proposed source rule for anticipated and unanticipated exchange gain corresponds to the source rule for interest.

The proposals for translating books and records maintained in a foreign currency generally would rationalize the translation rules for income earned by foreign branches and subpart F income of a foreign corporation. The Bon Ami rule for translating actual distributions from a foreign corporation and associated deemed paid taxes at the current exchange rate follows current law and maintains a consistent relationship between the amount of the distribution and foreign taxes deemed paid. However, the Administration will continue to consider alternatives to Bon Ami.

REFORM MIRROR SYSTEM OF TAXATION FOR UNITED STATES POSSESSIONS

General Explanation

Chapter 15.05

Current Law

In General

The income tax laws of the United States are in effect in Guam, the Commonwealth of the Northern Mariana Islands ("CNMI"), the U.S. Virgin Islands, and American Samoa as their local income tax systems. These jurisdictions are "possessions" of the United States for tax purposes. To transform the Internal Revenue Code of 1954, as amended (the "Code"), into a local tax code, each possession, in effect, substitutes its name for the name "United States" where appropriate in the Code. The possessions generally are treated as foreign countries for U.S. tax purposes. Similarly, the United States generally is treated as a foreign country for purposes of possessions taxation. Although this word-substitution system, known as the "mirror system", applies to Guam, the CNMI, the Virgin Islands, and American Samoa, the U.S. tax relationship with each possession is governed by somewhat different rules, as described below.

Guam

Under the Organic Act of 1950, Guam currently employs the mirror system of taxation. Under Code section 935, an individual resident of the United States or Guam is required to file, with respect to income tax liability to those jurisdictions, only one tax return -- with Guam if he is a Guamanian resident on the last day of the taxable year, or with the United States if he is a U.S. resident on the last day of the year (the "single filing rule"). Income taxes withheld by the jurisdiction in which a return is not filed may be claimed as a credit against tax imposed by the jurisdiction of filing. In addition, with respect to taxation of U.S. and Guamanian citizens and resident individuals (but not corporations), the U.S. is treated as part of Guam for purposes of Guamanian taxation, and Guam is treated as part of the United States for purposes of U.S. taxation.

A corporation chartered in Guam that receives U.S. source income (other than certain passive income) must file a U.S. return and pay U.S. tax on that income. Under Code section 881(b), a Guamanian corporation is not treated as a foreign corporation for purposes of the 30% withholding tax on certain passive income paid to foreign corporations if (a) less than 25% in value of its stock is owned by foreign persons, and (b) at least 20% of its gross income is derived from sources within Guam.

Under U.S. law, Guam is authorized to impose up to a 10% surtax on income tax collected under the mirror system and may provide for rebates of mirror system taxes in certain circumstances.

Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, applies to Guam. In effect, a section 936 corporation operating in a possession such as Guam enjoys an exemption from all U.S. tax on the income from its business activities and qualified investments in that possession. To qualify for this treatment, the section 936 corporation must meet two conditions: (a) at least 80% of its gross income for the three-year period immediately preceding the close of the taxable year must be from sources within the possession; and (b) at least 65% of its gross income for that period must be from the active conduct of a trade or business in the possession.

Federal statutes do not permit Federal employers to withhold territorial income taxes. However, under code section 7654, the United States generally covers into (i.e., transfers to) the treasury of Guam certain tax collected from individuals on Guamanian source income and withholding tax on U.S. military personnel stationed in Guam. Similarly, Guam covers into the treasury of the United States certain tax collected from individuals on U.S. source income.

CNMI

As of January 1, 1985, the CNMI is required to implement the mirror system in substantially the same manner as the mirror system is in effect in Guam. Code references to Guam are deemed to include the CNMI. Thus, the single filing rule for individuals under Code section 935 and the special withholding tax rule for interest and other passive income earned by corporations under section 881(b) also apply to the CNMI. In addition, U.S. law provides that the CNMI may by local law impose additional taxes and permit tax rebates, but only with respect to taxes on local source income.

Virgin Islands

Under the Naval Appropriations Act of 1922, the income tax laws of the United States, as amended, are held to be "likewise in force in the Virgin Islands", except that the proceeds of the income tax are paid into the treasury of the Virgin Islands. The courts have interpreted this provision to establish a mirror system of taxation in the Virgin Islands.

Under the Revised Organic Act of the Virgin Islands, as interpreted by the courts, an "inhabitant" of the Virgin Islands is exempt from U.S. tax as long as it pays tax to the Virgin Islands on its worldwide income. The term "inhabitant", for these purposes, has generally been interpreted to include individual residents of the Virgin Islands, corporations organized under the laws of the Virgin Islands, and corporations not organized under the laws of the Virgin Islands if such corporations have contacts with the Virgin Islands sufficient to establish "residence" in the Virgin Islands.

Notwithstanding section 28(a) of the Revised Organic Act, Virgin Islands corporations, which are generally treated as foreign corporations, are liable for the U.S. 30% withholding tax on certain payments to foreign corporations. However, under Code section 881(b), a Virgin Islands corporation is not treated as a foreign corporation for purposes of this tax if (a) less than 25% in value of its stock is owned by foreign persons, and (b) at least 20% of its income is derived from sources within the Virgin Islands.

Under Code section 934, the Virgin Islands is generally prohibited from reducing or rebating taxes imposed under the mirror system, with the following exceptions: (a) the prohibition does not apply (with respect to taxes on income derived from Virgin Islands sources) in the case of a full-year Virgin Islands resident individual; and (b) the prohibition does not apply (with respect to taxes on non-U.S. source income) in the case of a Virgin Islands or U.S. corporation which derives at least 80% of its income from Virgin Islands sources and at least 65% of its income from a Virgin Islands trade or business. (Code section 936, which provides an incentive for U.S. corporations to invest in certain possessions, does not apply to investment in the Virgin Islands. However, Code section 934(b), in conjunction with section 28(a) of the Revised Organic Act, provides similar results.) Under Code section 934A, the 30% withholding tax on certain payments to foreign persons (including U.S. persons), as imposed under the Virgin Islands mirror system, applies to payments to U.S. persons at a reduced 10% rate (which may be further reduced by the Virgin Islands).

The Virgin Islands is authorized to impose up to a 10% surtax on the mirror system tax. Otherwise, the Virgin Islands does not have the power to impose local taxes on income.

American Samoa

Unlike the possessions described above, U.S. law permits American Samoa to assume autonomy over its own income tax system. In 1963, however, American Samoa adopted the U.S. Internal Revenue Code as its local income tax, thereby also adopting the mirror system of income taxation. While American Samoa has the power to modify the Code in its capacity as American Samoa's territorial tax, this authority has been exercised on few occasions, generally to simplify the Code and adapt it to the needs of American Samoa.

Under section 931, U.S. citizens who receive 80% or more of their gross income from sources within American Samoa and 50% or more of their gross income from the conduct of a trade or business in American Samoa are exempt from U.S. tax on income derived from sources without the United States. In addition, Code section 936 applies to qualifying U.S. corporations doing business in American Samoa.

Reasons for Change

The Internal Revenue Code, with all its complexities, is designed primarily to tax income in the highly developed U.S. economy. The

mirror system, which entails imposing the Code in its entirety as local law, may be wholly inappropriate for the island economies of the U.S. possessions. The possessions need tax systems that help them to pursue development policies independently and to exercise greater control over their own economic welfare.

The frequency and extent of revisions to the Code in recent years have highlighted the problems inherent in the mirror system. For example, in the possessions generally, a large portion of the revenue is collected from individuals in the lower tax brackets. Generally, the portion of local revenues collected from corporations and higher-income individuals is very small. Thus, any revisions to the Code that lower the tax rates on individuals (such as the rate reductions enacted by the Economic Recovery Tax Act of 1981 and those proposed in this report) could have a potentially harsh revenue effect on the possessions. In addition, revenue-neutral proposals that compensate for lowering tax rates by broadening the tax base may well not be revenue neutral in a possession where very little tax is collected from corporations or higher-income individuals.

The present mirror systems are very complex and the possessions often lack the resources to enforce these mirror systems effectively. Because of the difficulties of enforcement and the ambiguities and inconsistencies inherent in the mirror system, U.S. taxpayers are known to abuse the mirror systems without making real economic contributions to the possessions.

To promote fiscal autonomy of the possessions, therefore, it is important to permit each to develop a tax system that is suited to its own revenue needs and administrative resources. It is also important to coordinate the possessions' tax systems with the U.S. tax system in a rational manner in order to provide certainty and minimize the potential for abuse.

The deficiencies in the current mirror systems of taxation afflict each possession, though in differing respects. The close economic relationship between Guam and the CNMI has given rise to mirror system problems for which there is no clear solution, resulting, in some cases, in harsh consequences for residents of Guam. With respect to the CNMI, the mirror system of taxation went into force for the first time in 1985. The CNMI has repeatedly voiced its concern that it will have difficulty administering and enforcing the complex mirror system because of its lack of resources. In addition, American Samoa has had difficulty collecting tax from U.S. Government employees because of the United States' lack of authority to withhold Samoan tax from wages.

With respect to the Virgin Islands, the interaction of the Internal Revenue Code with the Virgin Islands Revised Organic Act and the mirror system gives rise to numerous areas of ambiguity and problems of interpretation. These technical difficulties have made administration of the law problematic, created a climate of uncertainty for investors, and raised the possibility of unintended tax benefits for

some and harsh consequences for others. In addition to fostering tax avoidance and tax evasion, the "inhabitant" rule of the Revised Organic Act, in conjunction with tax reductions authorized by the Virgin Islands, effectively permits United States corporations meeting certain requirements to derive income from a Virgin Islands business free of any U.S. tax and subject to reduced Virgin Islands tax rates. (Such corporations, generally described in Rev. Rul. 80-40, are known as "80-40" companies.) However, due to substantial uncertainty as to the operational requirements of the so-called "80-40" mechanism, it does not appear to have encouraged U.S. investment in the Virgin Islands to any appreciable extent. Moreover, where the mechanism is used, the resulting U.S. tax benefit (i.e., exemption from U.S. tax of the "80-40" corporation's income from all sources) bears no necessary relation to the corporation's investment in the Virgin Islands or employment of Virgin Islands residents.

Proposal

In General

The proposal outlined below is divided into two parts. The first part deals with reform of the mirror system in the Virgin Islands. This part of the proposal is based in large part on extended discussions with the Virgin Islands in recent years regarding mirror system reform. It differs from the proposals for the other possessions because of the unique history of the relationship between the Virgin Islands and the United States. The second part relates to reforming the mirror system of taxation in Guam, the CNMI, and American Samoa.

Virgin Islands

Changes relating to all taxpayers. Under the proposal, certain tax provisions not contained in the Internal Revenue Code would be repealed or amended. First, the "inhabitant" rule contained in the Revised Organic Act would be repealed, and provisions in the Act relating to the covering of taxes would be revised to reflect such repeal. Second, the provision in the Naval Appropriations Act establishing the mirror system would be clarified to ensure that, in "mirroring" the Internal Revenue Code, (a) the Virgin Islands is not treated as having any possessions, (b) provisions in the Code referring to the Virgin Islands or to other possessions are not themselves mirrored, (c) possessions other than the Virgin Islands are treated as foreign countries for purposes of the Virgin Islands mirror system, and (d) certain provisions not intended to be included in the Virgin Islands mirror code are not mirrored. Third, the Revised Organic Act would be amended to provide the Virgin Islands with authority to enact nondiscriminatory local income taxes in addition to those imposed under the mirror system. Fourth, measures coordinating the tax administration and collection functions of the Internal Revenue Service and the Virgin Islands Bureau of Internal Revenue, as well as procedures for exchanging tax information, would be implemented.

Additionally, the 80 percent and 65 percent requirements contained in Code section 934(b) would be eliminated with respect to U.S. corporations (other than corporations validly electing to be covered by the five-year grandfather protection for existing section 934(b) corporations, as described in Ch. 12.05). Moreover, consideration would be given to authorizing the Virgin Islands to reduce or rebate the tax liability of certain foreign persons with respect to income derived from Virgin Islands sources.

Changes relating only to individuals. The tax treatment of individuals who are citizens or residents of the United States or the Virgin Islands would be modified through amendments to the Code. Under the proposal, for purposes of determining the tax liability of such individuals, the United States would be treated as including the Virgin Islands (for purposes of determining U.S. tax liability), and the Virgin Islands would be treated as including the United States (for purposes of determining liability for the Virgin Islands tax). However, a corporation organized in one jurisdiction would continue to be treated, where relevant, as a foreign corporation for purposes of individual income taxation in the other jurisdiction.

An individual qualifying as a bona fide Virgin Islands resident as of the last day of the taxable year (determined under general principles of Federal income tax law in effect prior to the enactment of section 7701(b)) would pay tax to the Virgin Islands under the mirror system on his worldwide income, and would have no final tax liability for such year to the United States. Any taxes withheld in the United States from payments to such an individual, and any estimated tax payments properly made by such an individual to the United States, would be covered into the Virgin Islands treasury and would be credited against the individual's Virgin Islands tax liability. A Virgin Islands resident deriving gross income from sources outside the Virgin Islands would list all items of such income on an attachment to his Virgin Islands return. Information contained on these attachments would be compiled by the Virgin Islands Bureau of Internal Revenue and transmitted to the Internal Revenue Service to facilitate enforcement assistance.

In the case of a citizen or resident of the United States (other than a bona fide Virgin Islands resident) deriving income from the Virgin Islands, tax liability to the Virgin Islands would be a fraction of the individual's U.S. tax liability, based on the ratio of adjusted gross income derived from Virgin Islands sources to worldwide adjusted gross income. Such an individual would file identical returns with the United States and the Virgin Islands. The individual's Virgin Islands tax liability (if paid) would be credited against his United States tax liability. Taxes paid to the Virgin Islands by the individual other than the tax paid pursuant to the mirror code would be treated, for U.S. tax purposes, in the same manner as State and local taxes.

In the case of a joint return filed by a couple of which only one spouse qualified as a resident of the Virgin Islands, resident status of both spouses would be determined by reference to the status of the spouse with the greater adjusted gross income for the taxable year. Rules for the payment to the Virgin Islands of estimated taxes by a U.S. resident would also be provided.

Changes relating only to corporations. Under the proposal, Code section 881(b) would be amended by deleting the 20% source-of-income requirement and adding, in its place, a requirement that 65% of the corporation's income be effectively connected with a trade or business in a possession or in the United States. In addition, the exemption from the withholding tax would not be available for a corporation used as a conduit for payments to persons not resident in the Virgin Islands. Generally, the branch profits tax described in Ch. 15.03 would not apply to a corporation qualifying under Code section 881(b).

For purposes of the wage credit described in Ch. 12.05, the Virgin Islands would be treated as an eligible possession. Moreover, U.S. corporations that have validly qualified for the benefits of section 934(b) for their last taxable year beginning on or before December 31, 1985 would be allowed to elect to be covered by the five-year grandfather protection extended to existing section 936 corporations, as described in Ch. 12.05.

Guam, the CNMI, and American Samoa

Guam and the CNMI would each be granted full authority over its own local income tax system, subject to certain qualifications discussed below. Thus, as is currently the case with respect to American Samoa, either possession could adopt a mirror system as its local law if desired. The tax systems implemented by Guam and the CNMI would raise at least as much revenue as the mirror systems currently implemented in those possessions.

American Samoa already has autonomy with respect to its local tax system, but certain anti-abuse provisions described below would apply to American Samoa as well as Guam and the CNMI.

A resident of Guam or the CNMI would be required to file a U.S. return if he received U.S. or foreign source income. However, he would be required to pay U.S. tax only if he received more than a threshold amount of income, including U.S. source income, from sources outside these possessions. The threshold amount would approximate the tax exempt threshold for U.S. individual taxpayers (i.e., the zero

bracket amount plus one or two personal exemptions, depending on filing status). The United States would cover into the treasury of Guam or the CNMI all U.S. income tax paid by a Guamanian or CNMI resident.

Code section 881(b) would be modified to provide that a Guamanian or CNMI corporation would not be exempt from the 30% withholding tax unless (a) less than 25% in value of the corporation's stock were owned by foreign persons; and (b) 65% of the corporation's income were effectively connected with the conduct of a trade or business in a U.S. possession or in the United States. In addition, the exemption from the withholding tax would not be available for a corporation used as a conduit for payments to persons not resident in the possession. A similar exemption provision would be enacted with respect to the branch profits tax described in Ch. 15.03 imposed on a U.S. branch of a Guamanian or CNMI corporation.

Qualifying U.S. corporations doing business in Guam, CNMI, or American Samoa would be eligible for the wage credit and the five-year grandfather protection for existing section 936 corporations, as described in Ch. 12.05.

For purposes of determining the U.S. tax liability of a Guamanian or CNMI resident, a dividend paid by a Guam or CNMI corporation would be deemed to be income derived from sources within Guam or the CNMI only if 50% or more of the corporation's gross income were derived from sources within those possessions.

Anti-abuse provisions would be implemented to coordinate the source rules, subpart F, and foreign personal holding company provisions to prevent the use of holding companies incorporated in Guam, CNMI, or American Samoa by U.S. or foreign persons to avoid U.S. tax, and to avoid application of those provisions in a non-abusive situation. Additional provisions would be enacted to eliminate certain reporting requirements with respect to Guamanian or CNMI residents who are not subject to U.S. tax. Local taxes of Guam, the CNMI, and American Samoa would be creditable for U.S. tax purposes if such taxes qualified as creditable taxes under the applicable foreign tax credit regulations.

Guam, the CNMI, and American Samoa would be prohibited from imposing discriminatory taxation on citizens and residents of the United States. These possessions would be required to exchange tax information with the United States under a mutually agreed upon procedure. Each would be authorized to enter into mutual agreement procedures and agreements to coordinate tax administration and withholding. Withholding on the compensation of U.S. Government personnel stationed in Guam, including military personnel, would be covered into the Guamanian, CNMI, and American Samoan treasuries, as appropriate. Finally, taxation by Guam, the CNMI, and American Samoa of the same individual or entity would be coordinated. This coordination is necessary because of the close economic relationships among these possessions.

Effective Dates

Virgin Islands

The Virgin Islands proposal would be effective for taxable years beginning on or after January 1, 1986.

Guam, the CNMI, and American Samoa

The proposed grants of authority to Guam and the CNMI, as well as the conforming changes to U.S. law, anti-abuse provisions, and administrative provisions, would be effective as of January 1, 1986. However, the mirror codes currently administered by Guam and the CNMI would continue to operate mutatis mutandis as their respective local income tax laws until and except to the extent that each possession took action to amend its tax laws. The anti-abuse and administrative provisions with respect to American Samoa also would be effective as of January 1, 1986.

Analysis

The proposals would promote the important goal of fiscal autonomy in the possessions and would permit those jurisdictions to enact and enforce tax laws that suit their revenue needs and administrative capabilities. The proposals are designed to resolve the technical flaws in current law and to permit the possessions to rationalize their tax systems.

The proposal relating to Guam, the CNMI, and American Samoa would clarify and promote the ability of these possessions to pursue economic development unhindered by a complex tax code designed for an entirely different type of economy. The major elements of these proposals have been discussed over the past several years with representatives of Guam, the CNMI, and American Samoa in general terms. The governments of these possessions generally favor changes to the current mirror systems that would free them from the frequent (and often detrimental) revisions to the Internal Revenue Code.

Rationalizing the tax provisions relating to the Virgin Islands would accomplish the following: (a) simplify the tax treatment of individuals moving between the Virgin Islands and the United States, (b) rectify the inequitable treatment of U.S. individuals deriving income from the Virgin Islands, (c) enhance the ability of the Virgin Islands to attract foreign capital, and (d) eliminate known and unknown opportunities for avoidance and evasion of United States and Virgin Islands taxes through inappropriate but untested interpretations of the mirror system and the Revised Organic Act.